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APPROVED FOR
RELEASE DATE:
01-Sep-2009

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CIACPAS...NID 90-172JX...



Director of Central Intelligence

NATIONAL INTELLIGENCE DAILY

Wednesday, 25 July 1990



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CPAS NID 90-172JX

25 July 1990

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IRAQ-KUWAIT: Is Baghdad Bluffing?

Kuwait has reduced the alert level of its military forces, and [redacted] believes Iraq is only bluffing. The Kuwaitis probably are mistaken; Iraqi propaganda is attacking the US for exercises with the UAE while additional Iraqi troops, equipment, and supplies continue to pour into the Al Basrah region. [redacted]

Kuwait apparently is trying to reduce tension with Iraq by engaging Egypt to mediate. The Kuwaiti strategy is to defuse the situation through consultations and mediation until the OPEC meeting in Geneva tomorrow, [redacted]

[redacted] The Kuwaiti press is playing up Egyptian President Mubarak's visits to Baghdad, Kuwait, and Saudi Arabia yesterday and stressing Kuwait's interest in easing tension. The ruling family has avoided directly criticizing Iraqi press attacks on Foreign Minister Sabah, one of its members. [redacted]

In a memo to the Arab League yesterday, Iraqi Foreign Minister Aziz repeated accusations that Kuwait took advantage of Iraq's distraction during the war with Iran to encroach on Iraqi territory. Iraqi Deputy Prime Minister Hammadi complained of Kuwaiti intransigence on the longstanding border dispute, and the Iraqi press denounced the UAE for conducting military exercises with the US. [redacted]

Comment: Despite the massive Iraqi troop movements, Kuwait does not appear to be making major preparations to stop an invasion. Kuwait hopes restating its intention to abide by its quota at the OPEC meeting will shore up support among moderate Arab states. Kuwait's rulers probably would provide Iraq reconstruction aid in

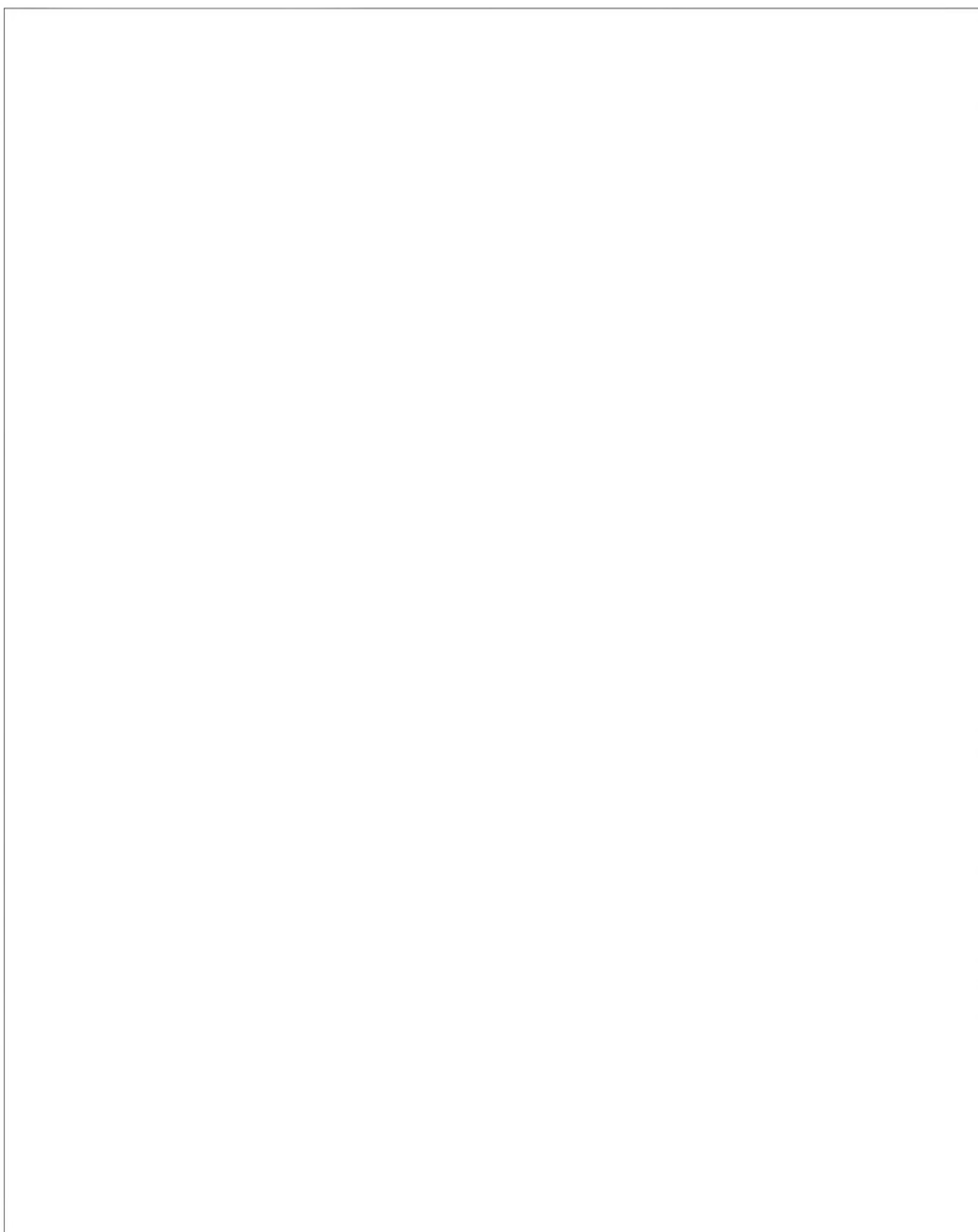
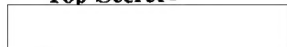
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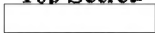
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a multilateral framework but will strongly resist giving Baghdad unilateral aid in the near future. They have experienced isolated military strikes against northern Kuwait in the past and probably would not retaliate for one now, but their resolve not to bow to Iraqi pressure probably would harden. [REDACTED]

Iraq probably is not bluffing; to accept less than satisfaction of its demands for reduced oil production and cash in the form of an Arab reconstruction fund would be a humiliating retreat. The stridency of Iraq's rhetoric and the cost of maintaining such a large military force along the Kuwaiti border also suggest Saddam Husayn will not wait long for a favorable response. Unless Kuwait moves to meet Iraq's demands quickly, Saddam is likely to turn up the pressure. [REDACTED]

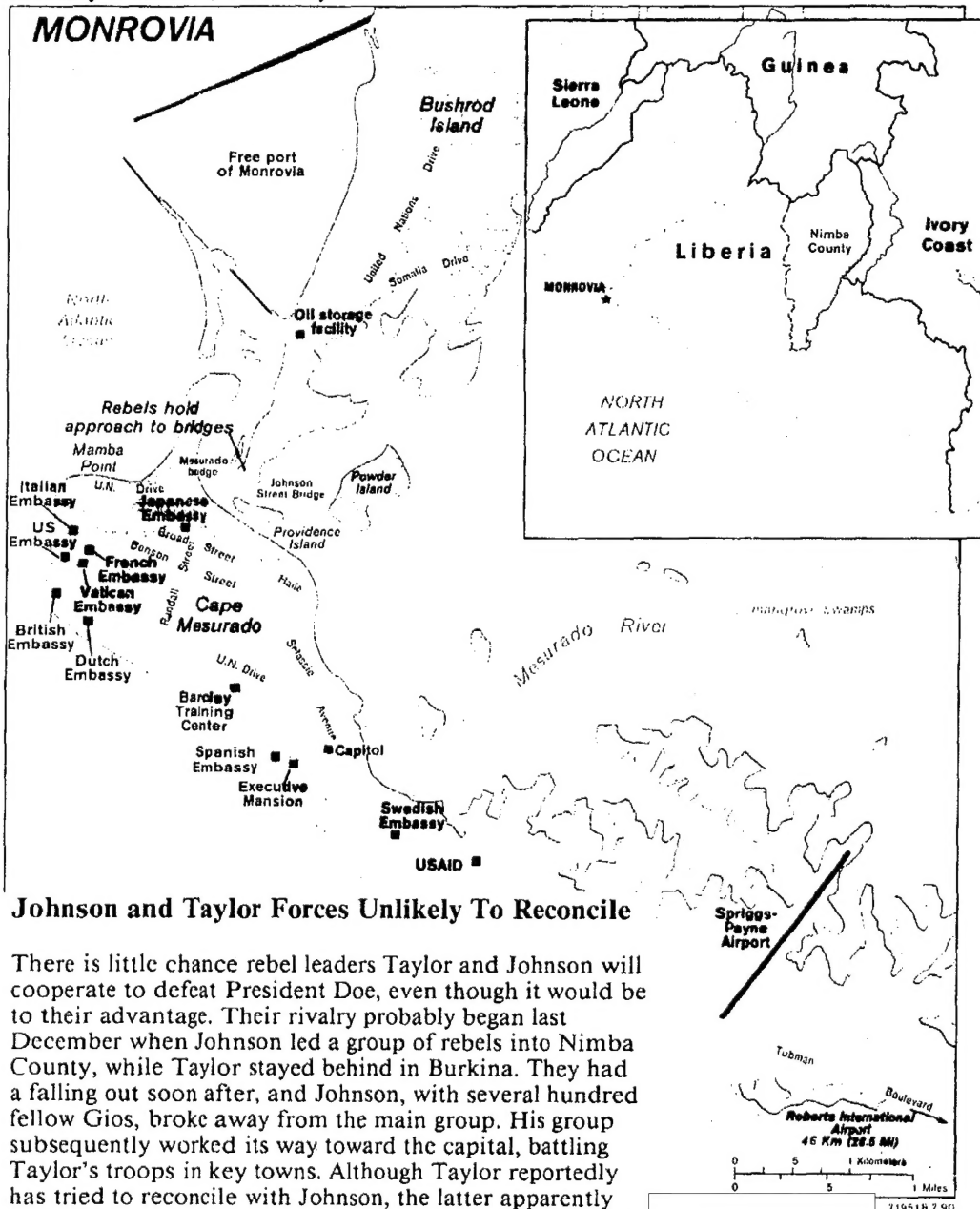
These apparently opposite courses increase prospects for a military clash. An initial Iraqi military move against Kuwait is likely to be a limited operation to increase the pressure on Kuwait to accede to Baghdad's demands. The force Iraq is building along the Kuwaiti border, however, will be able to carry out any military operation Saddam decides to undertake. [REDACTED]

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Military Situation, Late July 1990



Johnson and Taylor Forces Unlikely To Reconcile

There is little chance rebel leaders Taylor and Johnson will cooperate to defeat President Doe, even though it would be to their advantage. Their rivalry probably began last December when Johnson led a group of rebels into Nimba County, while Taylor stayed behind in Burkina. They had a falling out soon after, and Johnson, with several hundred fellow Gios, broke away from the main group. His group subsequently worked its way toward the capital, battling Taylor's troops in key towns. Although Taylor reportedly has tried to reconcile with Johnson, the latter apparently believes—probably unrealistically—he can defeat Doe and then deal with Taylor's forces, which are larger and better supplied.

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LIBERIA:

Fighting Subsides Temporarily

The rebels withdrew from downtown Monrovia yesterday, probably to regroup, as the government continued to fan anti-US sentiment. [redacted]

Sporadic shooting continued in Monrovia yesterday, [redacted] but there were no reports of rebels in the downtown area or changes in military positions. Bushrod Island was calm; the bridges there leading downtown are under rebel control. Evidence is mounting that rebel forces on the island are those of Prince Johnson, [redacted] but there are no accurate estimates of his troop strength. [redacted]

Monrovia continued to leave town, to safety behind rebel lines, but many still are seeking refuge within the city. The number of displaced persons at the US-leased housing compound across from the Embassy has risen to 5,000. Thirty to 40 others managed to enter the Embassy grounds yesterday but were persuaded to leave. [redacted]

The government continued to stir up anti-US sentiment in the army, [redacted]

[redacted] An official spokesman told reporters the US military may have shelled the Executive Mansion, claiming shell fragments found on the grounds following an alleged naval attack "looked" as if they came from a US submarine. [redacted]

Comment: The attack Monday on downtown Monrovia may be a continuation of rebel leader Charles Taylor's hit-and-run strategy. [redacted]

[redacted] It seems more likely, however, that Johnson's followers crossed over from Bushrod, battled army troops downtown, and then withdrew to the island. [redacted]

If the rebels were from Johnson's relatively small faction—strength estimates range from 200 to 700—they may lack the munitions and men required to sustain an assault on the capital. Their success so far probably stems from the fact that they attacked from the lightly guarded northern approach to the city that Taylor's forces had abandoned under international pressure to leave open the road to Sierra Leone. Taylor's troops, by contrast, have been forced to try to fight their way past heavily defended army posts, such as Camps Schieffelin and Ramrod at the southern entrance to the capital. [redacted]

Monrovia are increasingly likely to seek safehavens in the city as the fighting heats up, making it unsafe to try to leave. Large numbers are likely to stream into diplomatic compounds, particularly those that have been evacuated and probably only lightly guarded such as the British and Japanese Embassies. [redacted]

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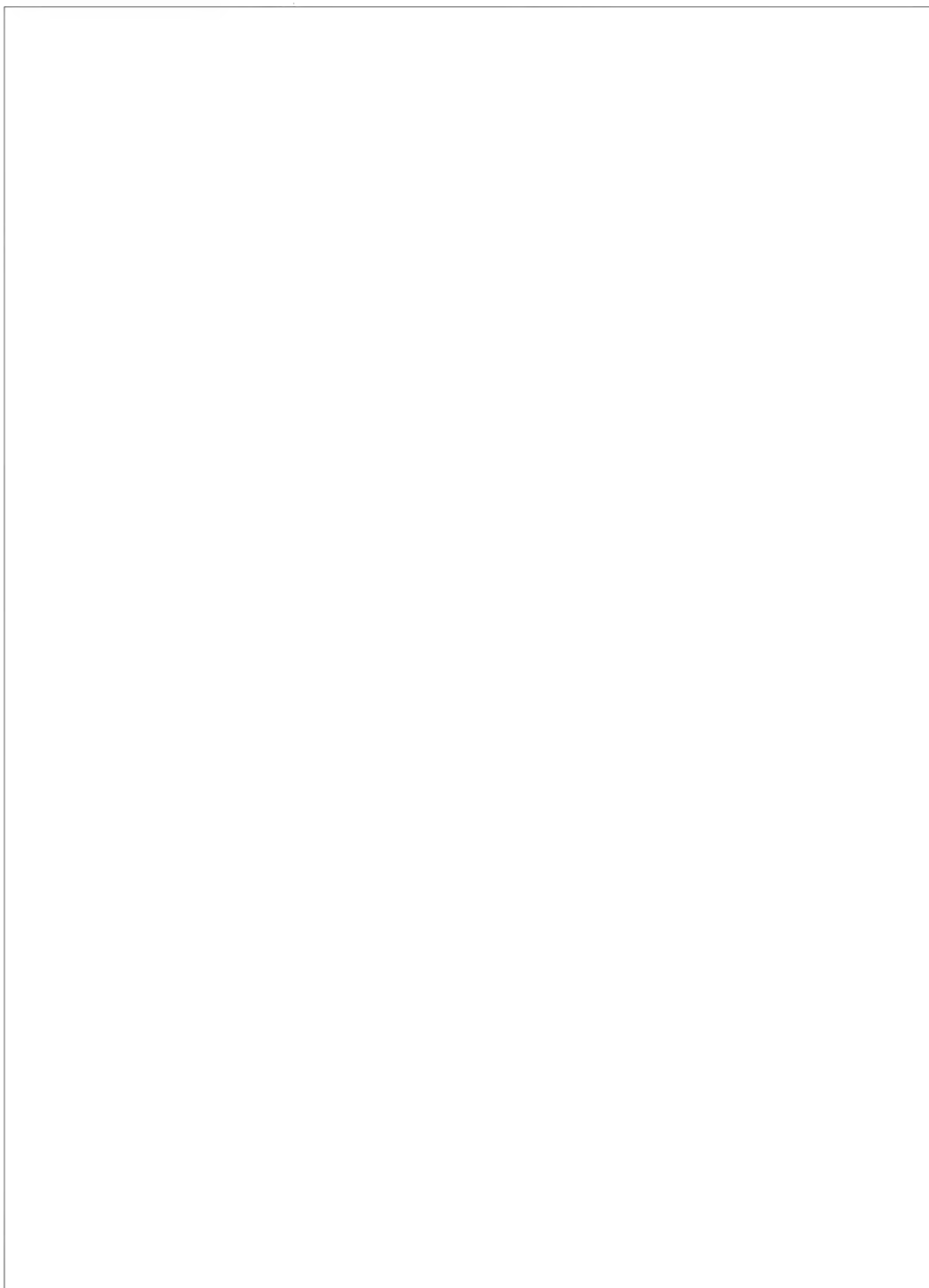


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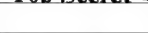
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USSR:

Problems Housing Returning Forces

The Supreme Soviet's Committee for Defense and State Security has called for a crash program to house Soviet personnel and families returning from Eastern Europe.

A delegation of Committee members recently toured Soviet facilities in four East European countries as well as garrisons of returning troops. The inspection reinforced the Committee's longstanding concern that the housing problem is too large and complex for the Ministry of Defense (MOD) to handle. The Committee has asked the Council of Ministers to designate the housing program a national task to be funded by a special appropriation.

The issue is attracting increasing attention in the Soviet press, including coverage of speeches by military delegates and political leaders at the recent CPSU and Russian Republic party congresses. Defense Minister Yazov this month told a reporter that housing is the number-one issue in the military districts where returnees are being stationed; he said the MOD plans to build 77 apartment blocks, eight barracks, and 156 prefabricated dormitories this year.

Comment: The MOD has struggled to fund the facilities, but resource constraints, bureaucratic snafus, and lack of raw materials have left it lagging far behind demand. Some 25,000 families will need housing over the next year, and the numbers will grow as troops come home from Germany and Poland.

The heightened attention politicians are giving this issue shows it appeals to traditionalist supporters of the military and to reform-minded politicians who hope to garner support among junior and midlevel officers. The government probably is also concerned that the housing shortage is contributing to declining military morale—already evident on a range of issues.

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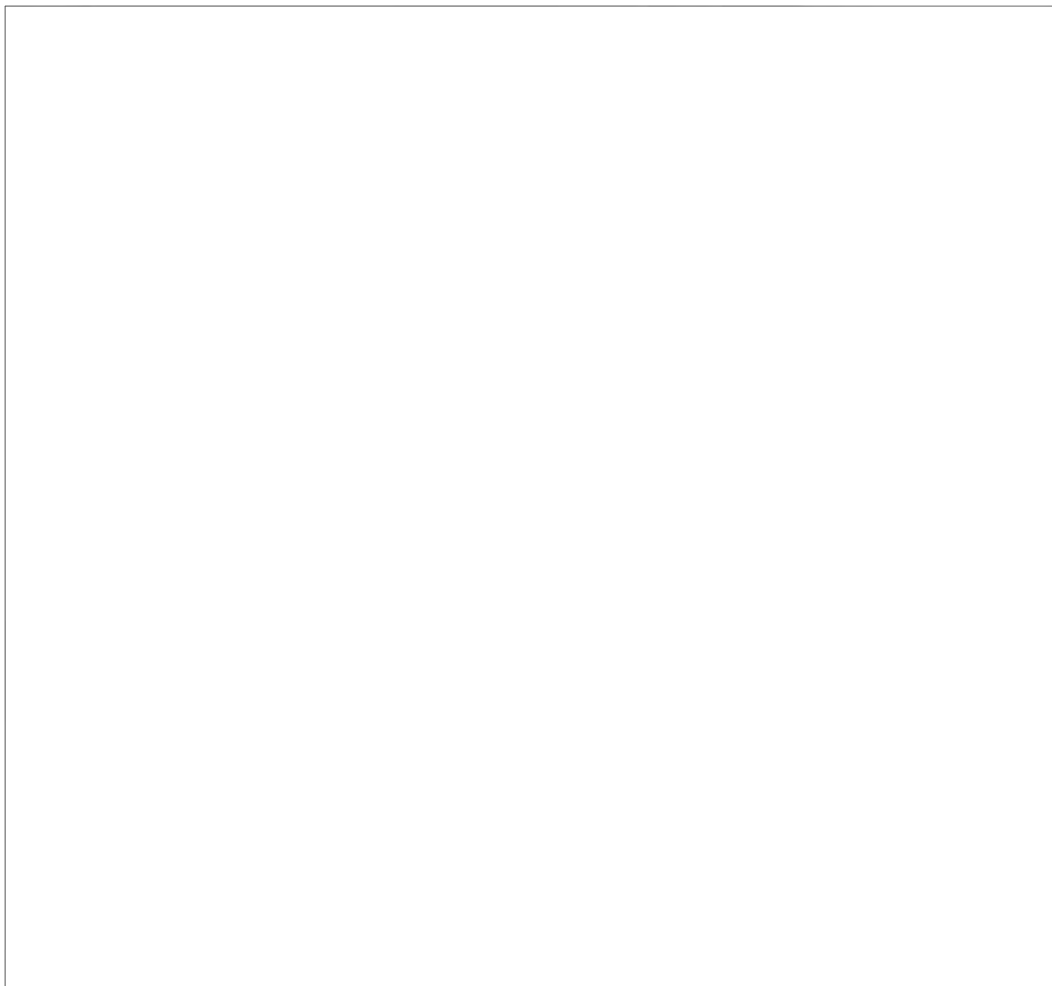


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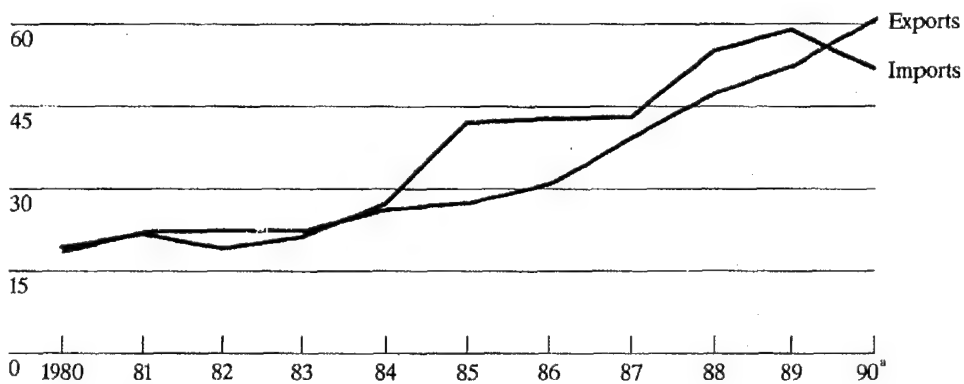
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Chinese Trade Trends

Imports and Exports

Billion US \$

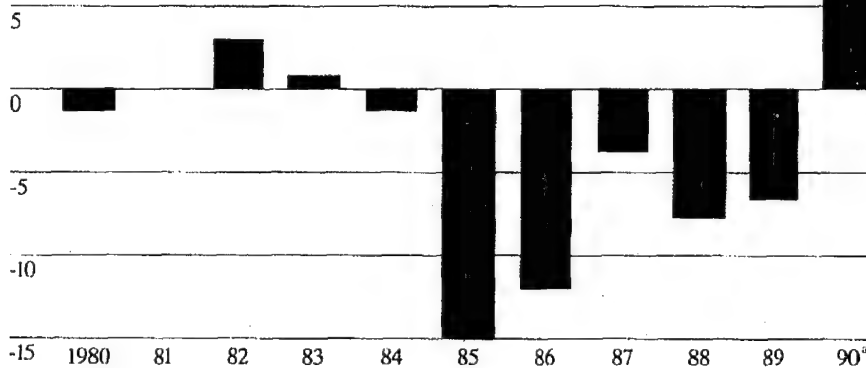
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Trade Balance

Billion US \$

10



^aProjected.

Source: Official Customs statistics.

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CHINA: Record Trade Surplus

Rapid export growth and tough import controls gave China a record \$2.6 billion trade surplus for the first half of this year. Exports were 15 percent larger than in the first half of last year, even though the value of textile sales, which account for more than a fourth of China's exports, slumped. Imports dropped 18 percent, with sharp cuts in purchases of grain, timber, pesticides, steel, and consumer goods. Foreign exchange reserves reached \$21.4 billion at the end of March, nearly 60 percent above the level posted immediately after last year's unrest.

Comment: Beijing wanted a large foreign exchange cushion because it was uncertain how Western sanctions would affect exports and access to credit. It is now under increasing domestic and foreign pressure to ease import restrictions.

China's export surge is likely to continue, however, aided by the improved competitiveness of its products resulting from last December's 21-percent currency devaluation, which is just beginning to be reflected in new export contracts.

TAIWAN: Stock Market Slide Threatens Policies

A 60-percent plunge in the stock market since February has put about a third of Taiwan's securities firms in the red and may force Taipei to abandon tight money policies. Rumors of insolvency have led to runs on credit cooperatives, which control almost one-tenth of the assets of financial institutions on the island and which reportedly have made illegal stock market margin loans in the past few years. The market weakness is due in part to growing overseas investment by Taiwan companies moving cash off the island to escape land, labor, and environmental regulations, as well as to the Central Bank's policy of restraining inflation, which reached 4.5 percent last year.

Comment: Price-equity ratios are still above those of other stock markets, and the market may drop further, increasing pressure on the government to reverse tight credit policies, to bail out failed credit cooperatives and securities firms, and to tighten regulation of the market. The ruling party, already racked by political infighting, will face increased criticism from the opposition; the average investor reportedly has lost more than \$12,000 in the slide. The authorities want to promote investor confidence so as to facilitate privatization of state-owned banks and industries by selling stock to the public.

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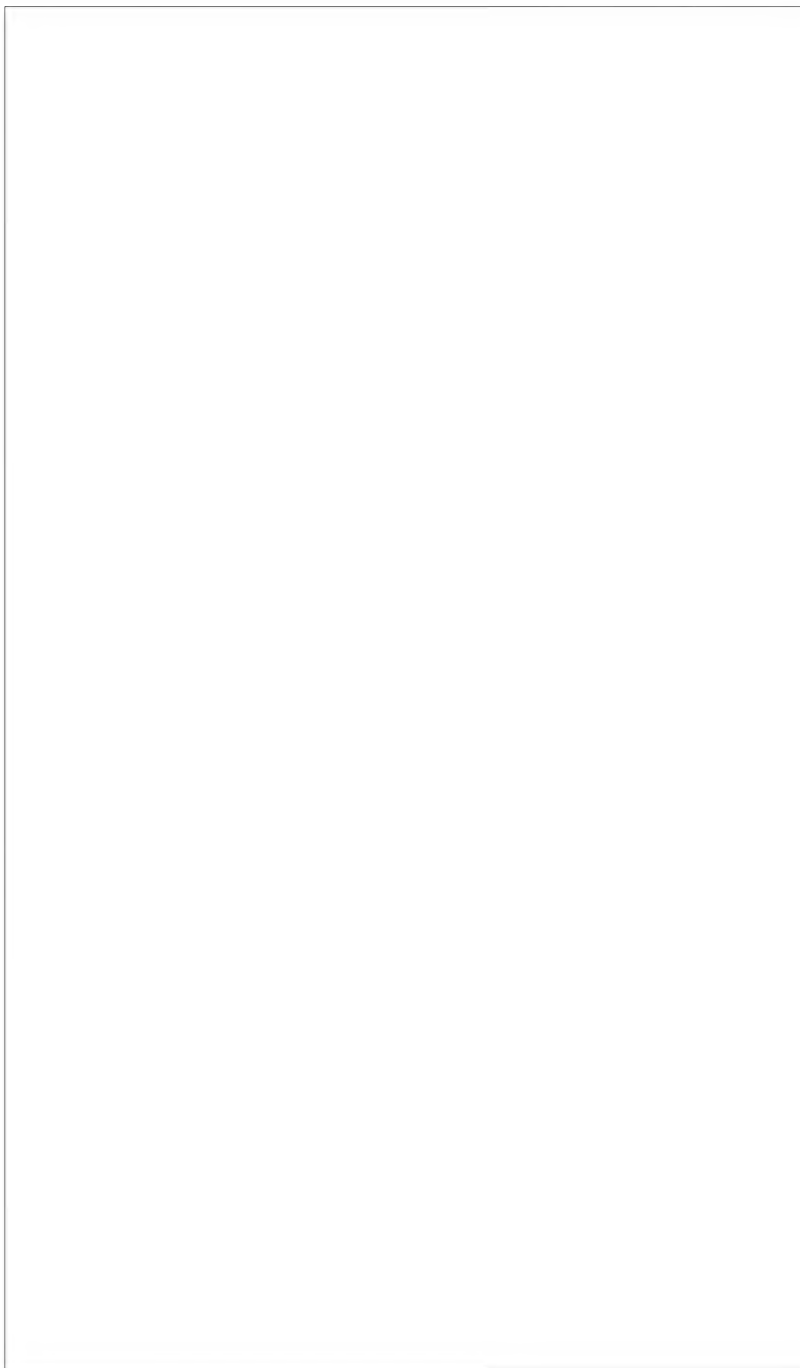


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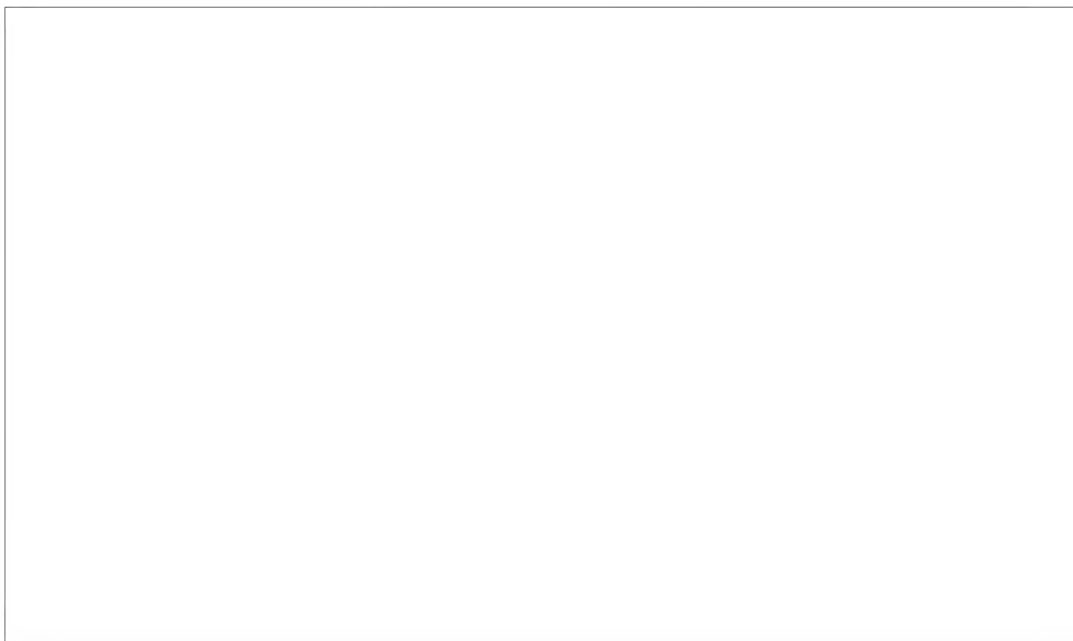


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~~Top Secret~~**EC: Moving Ahead on Aid to USSR**

The West Europeans are pushing ahead to provide economic assistance to the USSR despite the decision at the Houston summit to have the IMF lead a study of the Soviet economy. EC Commission President Delors' visit to Moscow last week laid the groundwork for a visit by an EC team of experts next month.

the head of the European Bank for Reconstruction and Development, which is involved in the IMF study, has already hired an adviser on Soviet economic issues.

Comment: Most EC governments probably hope to recapture the lead on the Soviet aid issue by finishing the Community study by October, two months before the summit-mandated study is due. Moreover, the EC probably believes the Soviets would rather deal with the Community than with the IMF.

Despite its eagerness to move forward, the Community remains far from identifying the best type of financial assistance; it is considering food aid, export credit guarantees, and loans to develop Soviet energy resources.

USSR-HUNGARY: Soviets May Repudiate 1956 Invasion

The USSR will soon reverse its stand on the invasion of Hungary in 1956. For months the Hungarians have been encouraging the Soviets to reevaluate the intervention. On Monday, the Hungarian legislature, calling the invasion "an act of cruel violence" and "a serious crime," formally appealed to the Soviet Government to admit that the invasion was illegal and to condemn it. Yesterday Soviet Foreign Ministry spokesman Gerasimov called the invasion "impermissible."

Comment: Moscow is trying to remove irritants in its relations with the new governments in Eastern Europe and has already condemned the invasion of Czechoslovakia in 1968 and acknowledged responsibility for the massacre of Polish officers at Katyn in 1941. It hopes a reassessment of 1956 will smooth relations with Budapest that have been strained by Soviet oil cutbacks, revelations of environmental damage from the Soviet military presence, and disagreement over compensation for bases evacuated by Soviet troops.

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In Brief

Middle East

- Arab media report Soviet Middle East envoy Tarasov's visit to Egypt, Syria, Jordan imminent . . . will brief on US-Soviet consultations, probably push Soviet proposal for five-party Arab talks on international peace conference.

USSR

- USSR radio reporting Kabul ransoming Soviet POWs from Afghan resistance this week . . . Moscow almost certainly funding efforts, attempting to assuage domestic criticism of continued involvement.
- Soviet press reports former KGB officer Kalugin being prosecuted for revealing state secrets . . . likely to trigger more attacks on KGB for continuing old ways, increase pressure for depoliticizing organizations.
- Soviets legalizing private hard currency holdings next week . . . for use in new hard currency stores or deposit in banks . . . may rechannel some hard currency to state coffers but will speed flight from ruble.
- Soviets Monday shut off water supply in Bryansk, southwest of Moscow, rationed reserves for at least a week . . . toxic chemicals spilled into river . . . will increase already substantial agitation for plant closings.

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Europe

- Liberals yesterday withdrew from **East German** ruling coalition over Prime Minister de Maiziere's resistance to 5-percent threshold in all-German election . . . majority intact but Social Democrats decide position tomorrow . . . Bonn coalition not affected.

East Asia

- Gorbachev wrote **South Korea's** Roh last week inviting "economic" delegation . . . top economic aide, national security adviser visit **USSR** next month . . . Moscow mainly seeking economic cooperation, Seoul wants diplomatic ties.

Americas

- **Paraguayan** President Rodriguez has dismissed Foreign Minister whose insistence on ruling-party preeminence at any cost incited widespread outrage . . . eliminates ineffective administrator, potential rival, reinforces Rodriguez's democratic image.

Africa

- **Zimbabwe** to lift 25-year-old state of emergency this week . . . ends sweeping extralegal security powers . . . probably reacting to similar **South African** action last month.

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Kuwait Draws Envy and Extortion

Kuwait's investment policy has made it the wealthiest government in the region and the envy of its less successful neighbors. Conservative estimates put Kuwaiti Government investments at \$70 billion and earnings at \$10.2 billion annually, more than oil revenues last year. The financial resources of autonomous government agencies and private citizens may exceed those of the government. Kuwait's overseas investments span the globe and include:

- More than 6,000 retail petroleum outlets in Western Europe.
- Two refineries, in Denmark and the Netherlands.
- A fleet of 20 tankers.
- Extensive real estate and financial holdings in the US, Western Europe, and Japan.

Kuwait sits atop the world's third-largest oil reserves and is home to only 570,000 Kuwaitis.

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Special Analysis

IRAQ-KUWAIT: Baghdad's Motivations and Intentions

President Saddam Husayn wants his current bullying to yield lasting political hegemony over Kuwait and a major voice in OPEC. Baghdad is pressing hard specifically for an end to OPEC overproduction and for massive Arab underwriting of its postwar economic recovery. The limited outcry from the Arab world and elsewhere over his tactics will encourage him to maintain a tough political and military stance well beyond this week's OPEC meeting.

Iraq has a long history of trying to extort cash and political concessions from Kuwait. On several occasions, notably in 1961 and in 1973, it threatened force only to be rebuffed by concerted international and Arab pressure.

Low Oil Prices Impede Postwar Recovery

The decline in oil prices between January and June cost Iraq more than \$1 billion in oil revenues. Foreign exchange receipts for the year probably will fall several billion dollars short of Baghdad's expectation. It has been forced to reduce spending and further squeeze discontented consumers. Iraq's foreign exchange reserves are enough to cover only about three months worth of civilian imports. Reconstruction and development projects have been delayed, including many in the oil sector. Growth in nonoil sectors also remains stalled.

Serious financial problems have prevented improvement in living standards depressed since early in the Iran-Iraq war. Attempts since the August 1988 cease-fire to improve supplies of consumer goods and reduce the 40-percent annual inflation rate have been largely ineffective. Saddam's continued spending on what many Iraqis view as frivolous items, such as the costly ceremonies to celebrate the reconstruction of Al Faw, probably has contributed to popular discontent and rumors of coup plots.

Baghdad's Options

Saddam, surrounded by sycophants, may only recently have found out that he must change his guns-and-butter policy. He probably is unwilling to reduce the several billion dollars spent annually to modernize the armed forces and

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develop Iraq's military industries. He also is reluctant to cut spending on the oil sector or on industrial projects that promise jobs for demobilized soldiers and more exports and that support military industrialization. Baghdad cannot increase oil exports; it is producing near its maximum sustainable capacity of about 3.3 million barrels per day.

Unwilling to trim spending and unable to expand oil production, Saddam is trying to raise oil prices by exploiting widespread sentiment in OPEC to rein in overproducers. Iraq has demanded that Kuwait and the UAE stop producing above their OPEC quotas. Baghdad has also demanded compensation for losses incurred because of Kuwait's perceived economic "aggression" against Iraq. Such compensation would include the establishment of an Arab reconstruction fund for Iraq.

The generally mild Arab and international reactions to Saddam's saber rattling along the border probably have encouraged him to increase pressure on Kuwait. The Gulf Cooperation Council—of which Kuwait and the UAE are members—thus far has refrained from actively supporting either country. Iran supports Iraq's effort to curb OPEC overproduction, according to press reports.

Outlook

Saddam is likely to continue pressing his demands for high oil prices and substantial financial assistance. To do less now would be a humiliating retreat. Even if the Arabs offer concessions, Baghdad is likely to keep troops along the border to ensure Kuwait keeps its end of the bargain.

Baghdad probably believes its aggressive propaganda, which has included personal attacks on Kuwaiti officials and members of the royal family, will provide it a pretext for some form of military action. Iraq almost certainly would use any seized territory to force Kuwaiti compliance with production ceilings, extort financial assistance, and press for a settlement of the border dispute. Iraq has long demanded control of Bubiyan and Warbah Islands to enhance its access to the sea. Saddam probably believes he has little to lose from a limited incursion, but he almost certainly fears that broader military action would bring the US into the fray and undermine his regional leadership aspirations. His long-term goal is to achieve political and economic domination of Kuwait. In OPEC, he wants to supplant Saudi Arabia as the key player.

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Moscow's Expectations

The Soviets hope their accommodation on Germany will pay off in a special relationship with Bonn based on the planned bilateral treaty. They are banking on this tie to help retain the USSR's key role in the region and give it greater influence in new institutions under CSCE even after the USSR completes its military withdrawal from Eastern Europe in 1994.

- Moscow expects Germany to promote further changes in NATO and new security relations in Europe through CSCE. Gorbachev and Shevardnadze last week called for early moves on a joint declaration by NATO and the Warsaw Pact and the establishment of a center for monitoring and resolving conflicts.
- The Soviets may hope that the security provisions of the treaty—such as the nonaggression pact—will press NATO and its member countries to follow suit.

Moscow apparently expects further negotiations or unilateral German actions to improve on the terms Gorbachev accepted.

- Although Kohl's commitment to limit German national forces probably will have been recognized in CFE beforehand, Moscow will press Bonn on other European arms control issues, such as reductions in other foreign forces as the Soviets withdraw and extending the ban on nuclear weapons to western Germany.

Kohl apparently did not offer new economic assistance, but Moscow is counting on strong economic ties and has emphasized to its domestic audience that economic benefits are expected. The Soviets probably recognize, however, that there are limits to the subsidized credits Bonn can offer and that cooperation will mainly take other forms.

- Moscow undoubtedly will welcome German technical advice and participation in resource development and other projects to earn hard currency, proposals German officials are advocating.
- In multilateral organizations, Soviet officials expect Bonn to continue pushing for increased aid to Moscow and to support Soviet bids for membership.

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Special Analysis

GERMANY-USSR: Relations in the Postunification Era

The treaty on bilateral relations that the Soviets and Germans are to negotiate will establish Germany's expanded influence in Europe. For Chancellor Kohl, the treaty will formalize Moscow's acceptance of Germany as its most important European interlocutor. Foreign Minister Genscher will try to make the pact a keystone in a new European "peace order" that still includes the US and the USSR but in significantly reduced roles.

[redacted] treaty negotiations will begin soon and that Soviet officials want to complete the draft as soon as possible next year, probably for signature during a Gorbachev visit. The precise terms probably will be less important than the German approach to the new relationship and the way Germany uses the treaty to shape its Western policies.

Shaping the New Europe

On the economic front the treaty will specify areas for cooperation, including credits for sales of German capital goods, German technical advice, expanded trade, and exploitation of Soviet natural resources. Postunification euphoria is likely to feed the longstanding convictions of many Germans that they can best teach the Soviets how to run their economy. The Germans are also likely to see the economic provisions of the treaty as a mandate to push Group of Seven and EC partners to increase aid to "help" *perestroyka*.

Genscher may envisage the treaty, coupled with the treaty-based relationship between the US and EC he has called for, as key to integrating Moscow and Washington into a new European peace order that guides Germany while letting the Germans lead. By the

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mid-1990s a successor government to Kohl's could cite the German-Soviet treaty's call for disarmament as justification for rejecting NATO nuclear modernization initiatives and for pressing France and the UK to include their nuclear forces in arms talks. [redacted]

After Soviet Withdrawal From Eastern Europe

In the 1990-94 period, the Germans' interests will be dominated by preventing any delay in Soviet troop withdrawals from former East German territory and elsewhere in Eastern Europe, but later they may see less reason to take account of Soviet concerns. The relationship could even take a turn for the worse if instability develops in Eastern Europe or in the USSR:

- If, for example, *perestroyka* continues to falter, the Germans might raise Soviet ire by trying to dictate reform, or alternatively might lose interest in leading efforts to prop up the Soviet economy.
 - If Soviet domestic troubles appear to preclude Moscow from playing a role in day-to-day European affairs, the Germans may increase their already growing economic and political presence in Eastern Europe regardless of Moscow's concerns.
- [redacted]

Much press commentary now centers on the danger of a "new Rapallo," but economic ties and growing institutional links to West European partners are powerful constraints to any German-Soviet condominium. The economic weakness and potential political instability on Germany's eastern borders, in contrast, provide few constraints on German activism in the region, a prospect that could worry East Europeans and the Soviets. [redacted]

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